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March 12, 2004

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Comptroller of the Currency
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Donald E. Powell
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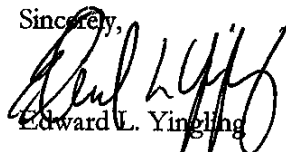
Dear Madam and Sirs:

In November 2001, I wrote to your agencies about the FASB's new rules relating to the accounting for goodwill, and requested that you address the treatment of goodwill for regulatory capital purposes by adopting rules that permit goodwill to be deducted "net of tax." A copy of the letter is attached.

Although I realize that many intervening events have taken place to divert attention away from this issue, I would request on behalf of ABA member banks that you reach a final determination on this matter. Your staffs have done a great deal of work on this issue, and we believe that the agencies should now be able to make a determination. Of course, if there is any further information we might provide, we would be pleased to do so.

Thank you for your attention to this.

Sincerely,


Edward L. Yingling



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November 7, 2001

Governor Laurence Meyer
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As you know, the Financial Accounting Standards Board (FASB) recently issued new rules relating to the accounting for goodwill, with an effective date for fiscal years beginning after December 15, 2001. We believe that, because of the new accounting requirements, regulatory capital rules relating to the treatment of goodwill should be amended. We are writing to you to request that the agencies focus – as soon as possible – on the treatment of goodwill for regulatory capital purposes by adopting rules that permit goodwill to be deducted “net of tax.”

The ABA brings together all categories of banking institutions to best represent the interests of the rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

Many of our members are eager for you to revise regulatory standards to either fully or partially eliminate the deduction of goodwill from regulatory capital. We have had discussions with representatives from each of your agencies over the past several months and recognize the regulatory and legislative difficulties in fully

eliminating the deduction of goodwill from regulatory capital in the short term. However, we believe it is possible and technically correct to adopt rules that will permit goodwill to be deducted from capital on a "net of tax" basis, and we request that you evaluate this recommendation as soon as possible.

FASB 142

Statement of Financial Accounting Standards No. 142 "Goodwill and Other Intangible Assets" (FASB 142) relates to the accounting for goodwill and other intangible assets. Generally effective for fiscal years beginning after December 15, 2001, goodwill will no longer be amortized for book purposes; instead, it will be tested for impairment at least annually. The impairment test will compare the fair value of goodwill to its book value. If book value exceeds fair value, an impairment loss will be recognized and the adjusted amount will become its new book basis.

The accounting changes made by FASB 142 have heightened the importance of the "net of tax" issue. First, all business combinations will now be accounted for as purchases with goodwill recognized on the balance sheet; thus, the level of goodwill that will be recognized in the industry is expected to increase as mergers continue. Second, the new standard provides a new and disciplined approach to accounting for goodwill – one that requires a robust assessment and monitoring of the value of recorded goodwill in lieu of amortization. Third, as a result of financial statement vs. tax differences, a tax benefit will exist. If goodwill must continue to be deducted from Tier 1 capital, then the full amount of the future tax benefit should be used to reduce the carrying value of goodwill prior to that deduction.

Goodwill for book, tax, and regulatory purposes

The following summarizes how goodwill is treated for financial statement, income tax, and regulatory capital purposes:

Financial statement purposes: Goodwill is not amortized. Instead, similar to some other types of assets, it is only written down if it is impaired.

Income tax purposes: Goodwill is tax deductible (amortized) if it relates to asset acquisitions or acquisitions treated as asset acquisitions for tax purposes. It is non-deductible (not amortized) if it relates to other stock acquisitions. (The focus of this letter is only on tax deductible goodwill.)

Regulatory capital: Goodwill is deducted from Tier 1 capital.

Accounting for income taxes

Paragraph 41 of FASB 142 describes the impact of goodwill upon deferred income taxes. As provided in Statement of Financial Accounting Standards No. 109,

"Accounting for Income Taxes" (FASB 109), deferred income taxes are not recognized for any portion of goodwill for which amortization is not deductible for income tax purposes. For tax deductible goodwill, FASB 109 provides guidance for the recognition of the related deferred income taxes.

If tax deductible goodwill has the same basis for income tax and book purposes at each balance sheet date, then no deferred tax asset or liability exists. However, under FASB 142, because goodwill will not be amortized for book purposes, it is more likely that tax deductible goodwill will be subject to deferred tax accounting. In other words, as goodwill is amortized and deducted for income tax purposes, a deferred tax liability will be accrued because, all other things being equal, the book basis (which will not reflect amortization of goodwill) will be greater than the tax basis.

This difference will not be settled until some indefinite future period when the goodwill is sold, impaired or otherwise disposed of. The deferred tax liability is one that is unlikely to result in a real liability. For example, if goodwill becomes impaired, the liability will be written off. If goodwill is settled by sale, then a multiple of the associated goodwill will be converted into liquid capital through a sale at a tax gain. In either case, it would seem inappropriate to penalize capital for the expense arising from the deferred tax liability.

"Net of tax" treatment for Tier 1 capital

We believe that it is appropriate to deduct goodwill from Tier 1 capital on a "net of tax" basis. The Capital Adequacy Guidelines define goodwill as an intangible asset that represents the excess of the purchase price over the fair market value of identifiable assets less liabilities assumed in acquisitions accounted for under the purchase method of accounting. To the extent an institution will receive an income tax benefit in its income tax returns for the allowable amortization deduction, the regulatory agencies should allow a reduction in the book value of goodwill to the extent of the tax benefit prior to reducing Tier I capital by the unamortized value of goodwill. By netting the income tax benefit against the goodwill carrying value, the true excess value of goodwill would be subtracted from Tier I capital.

To demonstrate the "net of tax" treatment, assume that Company A acquires Company B in an asset acquisition and pays the shareholders of Company B a premium of \$3,000. Also assume that the entire premium is goodwill that is not impaired and an income tax rate of 40%. Under current rules, goodwill is not amortized for book purposes, but it is amortized for tax purposes. The current regulatory capital rules would require that Tier 1 capital be reduced by the book value of goodwill (\$3,000). However, this reduction does not recognize the income tax benefits related to the amortization of tax deductible goodwill. Over the life of the goodwill, the Tier 1 capital position of the institution would be enhanced by \$1,200 (\$3,000 times the income tax rate of 40%). Thus, instead of reducing Tier 1

capital by \$3,000, it would be reduced by \$1,800 ($\$3,000 - 1200 = 1,800$) of income tax benefits.

There is precedent for using this "net of tax" treatment. The proposed rules relating to the retained residual interest in asset securitizations or other transfers of financial assets (published in the Federal Register of September 18, 2000) provided that such assets be deducted from regulatory capital on a net of tax basis. This provision was included in the final rule recently adopted by the FDIC. In addition, the current regulatory guidance for mortgage servicing rights allows the deduction from capital of the excess of carrying value over fair value to be made on an after tax basis. There is also precedent in the accounting literature for netting the full amount of the tax benefit. In FASB 109, deferred tax benefits relating to net operating losses are recognized if the benefit can be realized from current and future earnings.

Although we believe that the "net of tax" treatment is technically sound and appropriate, we also recognize that some institutions could view it as additional regulatory burden. Therefore, we suggest that the agencies consider permitting this treatment rather than requiring it.

In conclusion, we strongly encourage you to address this issue as soon as possible. We hope that these comments are useful, and we are eager to discuss this letter with you or your staff in more detail. Please feel free to contact Donna Fisher (202-663-5318), ABA's Director of Tax and Accounting.

Sincerely,

Edward L. Yingling

cc: Michael Zamorski, Director, FDIC
Wayne Rushton, Chief National Bank Examiner, OCC
Richard Spillenkothen, Director, FRB
Richard Riccobono, Deputy Director, OTS
Bob Storch, Accounting Section Chief, FDIC
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